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Russias Arrest of Oligarch Mikhail Khodorkovskiy: Background and Implications for U.S. Interests

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Russia's Arrest of "Oligarch" Mikhail Khodorkovskiy: Background and Implications for U.S. Interests

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Summary

This report discusses the Russian government's arrest of "oligarch" Mikhail Khodorkovskiy in late October 2003 and other moves against his Yukos oil company. The background of the arrest and subsequent political and economic fallout are presented, as well as implications for Russia and U.S. interests. This report may be updated as events warrant. Related products include CRS Issue Brief IB92089, *Russia*, updated regularly.

Background[1]

The October 2003 arrest of Mikhail Khodorkovskiy (purportedly Russia's richest person) and other moves against his Yukos oil firm (among the world's largest in terms of reserves) have raised concerns among some U.S. policymakers and analysts about the status of economic and political reforms in Russia and repercussions for U.S.-Russia relations. Stepped-up Russian government moves against Yukos became public in July 2003 with the reopening of a supposedly resolved privatization fraud case and arrest of Platon Lebedev, a major Yukos shareholder and chairman of its holding company Menatep. Prosecutors also revisited other Yukos cases, many of which ostensibly had been settled or dropped, and launched several raids of Yukos and Menatep offices.

The Yukos probe heightened concerns among many of Russia's wealthiest businessmen — the so-called "oligarchs" who benefitted greatly from the controversial privatization auctions of state-owned companies in the 1990s — of a wide-scale government reexamination of their personal fortunes, corporate empires, and private property rights in general. Several prominent businessmen had implored Russian

[1] Sources for this report include the Foreign Broadcast Information Service (FBIS), *Central Eurasia: Daily Report*; *RFE/RL Newsline*; *Johnson's List*; the State Department's *Washington File*; and *Reuters*, *Agence France Presse* (AFP), *Associated Press* (AP), and other newswires.

President Vladimir Putin to intervene with prosecutors to release Lebedev and scale down the investigation, but Putin claimed that the "rule of law" demanded his noninvolvement. Then, on October 25, 2003, Khodorkovskiy was arrested and charged with fraud, embezzlement, and evading personal and corporate taxes. To purportedly protect the government's interest in collecting the taxes, the prosecutor impounded 44.1% (later reduced to 39.6%) of shares controlled by Khodorkovskiy and other Menatep members. The government seemed to be moving more broadly against Yukos in November with the opening of more investigations and the reported flight of several company officials to Israel. Stressing that he hoped to protect the future of Yukos, Khodorkovskiy resigned as chief executive on November 3. The next day, the Yukos board appointed Simon Kukes — a U.S. citizen and chief of a major Russian oil firm — to replace Khodorkovskiy.

Fallout of the Arrest

The fears of the oligarchs and others that privatization might be at least partially reversed has led Putin in recent weeks to declare that re-nationalization is not on his agenda. However, perceptions that private enterprise was being threatened appeared reinforced on October 29 when Putin's Minister of Natural Resources stated that oilfield exploration licenses granted to Yukos would probably be cancelled. Such perceptions may have been reflected in the plummeting share price of Yukos stock and in a Central Bank official's statement on November 10 that much-hailed net capital inflows during early 2003 had reverted to net outflows. However, Russian officials have allowed Yukos and the Sibneft oil firm to proceed with their merger, which reportedly creates the world's largest private oil firm in terms of reserves and the fourth-largest in terms of production.

Many analysts speculate that the arrest was orchestrated by a group of Putin's appointees linked to his career in the security service and in St. Petersburg, including presidential staffers Viktor Ivanov and Igor Sechin. This group, termed by some the "siloviki" (strong ones), came to oppose Alexander Voloshin, head of the presidential administration, who was appointed by former President Boris Yeltsin and had purported ties to many of the oligarchs. Facing his loss of influence within the administration and denouncing Khodorkovskiy's arrest, Voloshin resigned on October 30. Sechin and Ivanov may not have gained more influence, however, since Putin quickly appointed Voloshin's assistant, the reportedly moderate Dmitriy Medvedev, to replace him. Medvedev on November 2 appeared critical of the broadening investigation of Yukos, urging prosecutors to "think through all the economic consequences of their decisions" (*Novosti*, Nov. 3). Prime Minister Mikhail Kasyanov on November 11 likewise called on the government to ensure "unshakable" private property rights. Anatoliy Chubais, chief of the United Energy Systems electric utility (UES; 51% of shares are state-owned) and a leader of the Union of Right Forces party (supported by Khodorkovskiy) has been the most prominent company head to criticize Khodorkovskiy's arrest. Some observers have warned that Chubais — who during the 1990s led privatization efforts and is hence widely unpopular — may soon become a target of investigation.

It appears that after some temporizing, Putin moved during November to stanch the intense domestic and international criticism of the moves against Yukos and to prevent the case from seriously damaging Russia's energy sector and economic growth. On November 4, he argued that the Yukos case was similar to the U.S. Enron scandal and was a simple law enforcement matter, and the next day publicly rebuked his Natural

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Resources Minister for suggesting that licenses might be revoked, stating that "the state should not strive to destroy" Yukos. He also discussed the arrest on November 13 with the visiting head of the International Monetary Fund, Horst Koehler, who later stated that he was convinced that Putin remained dedicated to free markets. Putin the next day met with a large group of Russian businessmen and pledged to protect private property rights, but also pointedly warned them not to lobby legislators and bureaucrats for favors.

Implications for Russia

Some observers in Russia have explained moves by the Putin administration against the oligarchs in terms of a marker laid down by Putin in mid-2000. In a closed meeting with the oligarchs, Putin allegedly pledged not to revisit the privatization deals if they did not become involved in opposition political activities. These observers suggest that the Putin administration's prosecution of Khodorkovskiy, as well as earlier moves against prominent oligarchs, may be explained in part by the administration's displeasure over their political activities (*FBIS*, Sept. 16, Doc. No. CEP-89; Oct. 29, Doc. No. CEP-309; Oct. 30, Doc. No. CEP-316). In 2003, Khodorkovskiy had become active in funding liberal causes and opposition parties, and hinted that he might eventually run for president. His arrest and Putin's November 14 speech to businessmen served to drive home this message to stay out of politics, in this view.

While many Russian businessmen have argued that they have the rights of any citizen to lobby the government for preferred policies and to otherwise participate in politics, Putin has strongly asserted that their political influence should be limited. To these businessmen and other observers, the government's moves against Yukos have indicated that neither the rule of law nor public opinion appear to offer much support for their rights (*Economist Intelligence Unit*, Nov. 7). The moves against Khodorkovskiy and Yukos were politically orchestrated and belied the independence of the judicial system, according to this view, and confirmed that "neither democracy nor capitalism has taken hold in Russia." (*Washington Post*, Nov. 12). A poll taken by the respected ROMIR public opinion firm at the end of October indicated scant popular support for Khodorkovskiy, with over half of those who knew about his arrest (about one-fourth did not) endorsing it and believing that his company had broken the law (*Reuters*, Nov. 5).

A Sea Change of Policy? Some observers have warned that the moves against Yukos mark the launch of fundamental changes in politics and economics. U.S. analyst Stephen F. Cohen has argued that "the struggle over the oligarchical system, and thus once again the future of post-Soviet Russia, is under way," and that the result may be far-reaching economic changes, including the removal of the oligarchs (*The Nation*, Nov. 24). International financier George Soros has warned that Putin is creating "state capitalism," where the private sector is controlled by the state, while others have suggested that Putin aims to create Chinese-style capitalism, where Russian businessmen are not permitted to interfere in politics and foreign investment is controlled. Other implications may include greater efforts by Russia to use its energy firms as instruments of foreign policy, as advocated by Defense Minister Sergey Ivanov (a siloviki) on November 17.

Other analysts view the government's moves against Khodorkovskiy as designed mainly to wipe out his growing influence over Russia's energy sector and increase the influence of the government over this sector. These analysts suggest that Putin has had an interest since he became prime minister in 1999 in limiting the influence of the

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oligarchs over oil and gas resources. They assert that the State Duma's inability to enact bills backed by the government to broaden state controls over natural resource development (legislation that Khodorkovskiy lobbied against), calls by Yukos for an end to the Russian government's total ownership of pipelines, challenges to tax rates by Yukos, and rumors that major U.S. and foreign oil firms might become major shareholders in Russia's largest oil firm contributed to government's retaliation against Khodorkovskiy. U.S. analyst Anders Aslund, however, has discounted the government's interest in the oil sector, suggesting on November 4 that the moves against Khodorovskiy had primarily political motives of eliminating a rival for power (*Voice of America*, Nov. 5). Suggestive of this motive, Russia's deputy prosecutor has stated that Khodorkovskiy might be detained for up to two years or longer, well beyond the 2004 presidential race. Having blocked Khodorkovskiy's political ambitions, the Russian government will not further jeopardize economic growth, in this view. The privatizations of the 1990s, as well as the domination of the economy by monopolies and the state's partial or controlling interests in many major firms, will remain in place (*Moscow Times*, Nov. 13).

The Rise of the Siloviki? The Yukos case appeared to highlight increasing contention within the Putin administration over economic policy, with one group advocating some degree of free enterprise (the pro-oligarch "Yeltsinites," who are holdovers from the previous administration) and another group calling for more state control over the economy (the siloviki). The siloviki also tend to be more distrustful of ties with the West than the Yeltsinites. Putin has appeared to support the Yukos probe launched by the siloviki, although opinions differ among many observers on the degree of his support and control over them. To remedy the apparent rift within the Putin administration between the rising siloviki and the weakening Yeltsinites, Medvedev may be seeking to forge a compromise between them. Although weakened by Voloshin's resignation, the Yeltsinites appear to retain some influence through Prime Minister Mikhail Kasyanov. The strengthening of the siloviki faction appears to include growing support for it even among some administration moderates, such as Finance Minister Alexey Kudrin, who on November 3 welcomed the moves against Yukos as heralding a more honest marketplace. Some observers suggest that there are recent signs that the siloviki might be exceeding Putin's wishes (alternatively, they may be carrying them out), including reports that the Natural Resources Ministry and regional authorities are stepping up their threats to revoke Yukos licenses. The government also reportedly has eliminated some tax exemptions affecting Yukos and orchestrated the quick Duma repeal on November 18 of a Khodorkovskiy-influenced law that had limited export taxes on oil.

Investment Outcomes. The affair has appeared to delay some foreign investment, although some caution may have more to do with the uncertainties of the Russian election cycle than with the Yukos case, according to some analysts. However, the Yukos probe may have boosted investor concerns about the economic and political policies that might be pursued by Putin in his second term (Andrius Vilkancas, *Reuters*, November 9). Although foreign investment is significant for major projects and sectors, it currently plays a small role in the Russian economy compared to domestic investment by Russian firms. If there are further government moves against private property, Russian entrepreneurs might react by eschewing investments in plant and equipment and sending their capital abroad (*Financial Times*, Nov. 11). The International Energy Agency of the Organization for Economic Cooperation and Development warned on November 13 that Russian government moves against Yukos and possible delays in foreign investment could contribute to faltering production that may harm Russia's economic growth. More

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optimistically, the credit rating firm Moody's stated on November 12 that it would stand by its designation that Russian government bonds were investment-grade, reflecting its assessment that the Russian economy would retain strong growth. Several international energy and other firms have stated that they are not changing their investment plans.

Campaign Effects. Although much of the Russian public appeared to be unaware of or indifferent to the government's moves against Yukos, they have been prominently discussed by Duma candidates during campaigning ahead of the December 7 election. Putin's favored United Russia party bloc has appeared to gain support by attacking the oligarchs, effectively coopting an issue that was a staple of the Communist Party. The Communists also appeared compromised by accepting some support from some oligarchs and even listing them as candidates. Two parties that had received major support from Khodorkovskiy — Yabloko and the Union of Right Forces — warned of an assault on the market economy and the imposition of authoritarian rule. Their efforts to attract voters appeared severely set back both by the cutoff of Khodorkovskiy's funding and the perception of many voters that they represent the super-rich. Yabloko's popularity also may have suffered when its offices were raided in October, ostensibly as part of the Yukos case. A few observers have asserted that the Yukos investigation aims to discredit both the Communist Party and Yabloko in order to so reduce their appeal that they fail to meet a threshold for any party list seats in the Duma (*Moscow Tribune*, Nov. 21).

Implications for U.S. Interests

Opinions varied somewhat among U.S. policymakers and analysts about the significance of Russian government moves against Yukos and Khodorkovskiy to U.S. interests. Among those more critical of the Russian government, U.S. defense advisor Richard Perle on October 29 condemned Khodorkovskiy's arrest and called for Russia's exclusion from the Group of Eight (G-8) industrial nations (*Wall Street Journal*, Oct. 30). Others were more supportive of the Russian government, with one former U.S. official hailing Putin for revitalizing Russian democracy and comparing him to the trust-busting U.S. President Theodore Roosevelt (*Washington Times*, Nov. 11).

These differences of viewpoint were apparent in assessments of the Bush Administration's response to the arrest. Some viewed the response as muted and mainly restricted to background and off-the-record criticisms, while others viewed it as relatively forceful. Among official statements, the State Department on October 27 raised concerns about the "selective" nature of the arrest and the Russian government's "confrontational" moves against Yukos, and on October 31, stated that the impoundment of Yukos stock posed "serious questions about the rule of law in Russia," and "spark[ed] concerns among domestic and international investors about respect for ownership rights." Russian Foreign Minister Igor Ivanov two days later denounced these statements as interference in Russia's domestic affairs. Perhaps indicating a more muted response, Secretary of State Colin Powell stated on November 4 that "the case is playing out and I think it's best for us just to see how the Russians handle it." Seeming more forceful, White House spokesman Scott McClellan on November 6 stated that "the manner in which the case is being addressed has raised some serious concerns about the state of rule of law and the business and investment climate ... It's important for Russian authorities to dispel any concerns that this case is politically motivated."

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Energy and Other U.S.-Russia Ties. Some observers have raised concerns that the Yukos case could jeopardize the U.S. national interest in diversifying energy supplies, including growing oil imports from Russia (currently over 500,000 barrels per day), as well as development proposals such as a Russian Murmansk pipeline and port to supply oil for U.S. markets (*Dallas Morning News*, Nov. 10, p. 1D). They also caution the United States to closely monitor the status of the siloviki and the upcoming Russian elections, which could contribute to changes in Russian national security policy inimical to U.S. interests. Khodorkovskiy and Yukos have played a prominent role in meetings of the U.S. -Russia Commercial Energy Dialogue that were launched by Presidents Bush and Putin at their May 2002 summit. Khodorkovskiy highlighted plans for the Murmansk pipeline at the September 2003 Commercial Energy Summit (*Oil Daily*, Sept 23; *AFP*, Nov. 15). In addition, Khodorkovskiy's Open Russia Foundation charity has been hailed by U.S. officials as bolstering democratization in Russia (Amb. Vershbow, May 17, 2002). Some analysts argue that the Administration should not overreact to the moves against Yukos but should reaffirm core U.S. national interests by continuing to engage with Russia, to include cooperation on counter-terrorism, NATO, Afghanistan, and the nonproliferation of weapons of mass destruction to Iran and North Korea, as well as cooperation on energy development (*Reuters*, Nov. 4). (For details on U.S.-Russia ties and Russian foreign policy, see CRS Issue Brief IB92089, *Russia*.).

Many U.S. oil companies have indicated that despite the Yukos case, Russia's oil exports and reserves make it a world player that is hard to ignore. Perhaps reflecting a prevailing attitude, the chairman of the energy services firm Halliburton on November 5 stated that he hoped his firm would in the future play a big role in Russia, but that he had some concerns that rule of law problems "make the market iffy," in terms of profitability (*Reuters,* Nov. 5). Kukes' appointment as chief of Yukos (where he joins two other executives who are U.S. citizens) brings to the fore someone who previously worked for U.S. oil firms, perhaps boding well for future cooperation between Yukos or its successor and the U.S. energy sector.

Congressional Concerns. Several Members of Congress have been at the forefront in raising U.S. concerns about the Khodorkovskiy arrest and moves against Yukos. Meeting with Members of Congress on November 4 to formalize cooperative ties, the chairman of Russia's upper legislative chamber, Sergey Mironov, endeavored to reassure them that "there are no political, economic, or election goals," in the Yukos probe, and that U.S.-Russia ties therefore should not be negatively affected (*ITAR-TASS*, Nov. 4). Despite these assurances, that same day Senate Foreign Relations Committee chairman Richard Lugar introduced S.Res. 258, which calls for Khodorkovskiy's human rights to be respected and for Russia to dispel concerns that cases against business leaders are politically motivated and that the legal system is being misused. Also among the concerns are the Russian government's seeming preoccupation with prosecuting Jewish oligarchs. Senate Commerce Committee chairman John McCain also strongly warned that "a creeping coup against the forces of democracy and market capitalism in Russia is threatening the foundation of the US-Russia relationship," and called on the U.S. government to "cease all guarantees of investment in Russia due to the unacceptable risk of state interference and expropriation." The Russian Foreign Ministry responded by criticizing McCain for "lapsing into Cold War stereotypes," and "outrageously" trying to harm the U.S.-Russian "strategic partnership" (*CR*, Nov. 4, pp. S13866-7; *AP*, Nov. 4).

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